

## Food & Marketing



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### Food Prices Forecast Up 2.5-3 Percent In 1997

The Consumer Price Index (CPI) for food in 1997 is forecast to rise 2.5-3.3 percent, down from last year's 3.3-percent gain. The 1996 increase was the largest since 1990 when food was up 5.8 percent, and was slightly above the 2.9-percent increase for all goods and services.

The away-from-home component of the CPI is expected to increase 2-3 percent in 1997, compared with 2.5 percent in 1996. The higher Federal minimum wage, which went into effect in fall 1996, had minimal impact on the away-from-home index that year. While some upward pressure on the away-from-home index was expected, competition among restaurants and fast-food establishments remained strong and prevented the pass-through of higher wage and raw material costs to consumers. The at-home component of the CPI is expected to increase 2.5-3.5 percent in 1997, down from the 3.7-percent rise in 1996.

In spite of high grain prices last year, four major factors prevented a large runup in food prices in 1996 and should keep a lid on the impact of any commodity price advances this year. First, overall inflation (as measured by changes in the all-items CPI) remained stable at 2.9 percent in 1996 and is forecast to increase just above 3 percent in 1997. This means that costs related to food production and marketing—e.g., labor, packaging, transportation, and advertising—which account for about 75 percent of retail food costs, are not expected to increase substantially.

Second, the farm-value proportion of the U.S. food dollar, which has been on a declining trend and which stood at 22 cents in 1995, is expected to be about the same in 1996 and 1997. With a lower farm-value proportion (compared with 37 cents in 1973), retail food prices are determined less by farm commodity prices and more by market conditions for labor, packaging, and advertising, as well as by competition among firms.

Third, the trend of increasing economies of size in the agricultural sector is expected to continue. In particular, larger and more specialized pork, poultry, and beef (feedlot) operations have led to slower rising per-unit production costs.

Fourth, the away-from-home food sector, primarily restaurants and fast-food establishments, is much larger than two decades ago. Purchases of food away from home accounted for 47 percent of total food dollars spent in 1995, up from about a third in 1973, and are expected to be about the same in 1996 and 1997. A large away-from-home sector lessens the impact of rises in grain or other farm commodity prices on the overall food price index.

Changes in prices for away-from-home items are influenced more by developments in the nonfarm markets and by competition among restaurants and fast-food establishments, than by increases in farm commodity prices. The away-from-home food market has been very competitive since the recession of the early 1990's.

Rising grain prices from late 1995 through summer 1996 affected feed costs as well as retail prices for beef, pork, poultry, eggs, dairy products, and cereal and bakery products. Because these food categories account for over a third of the at-home food dollar, price changes for these items can have a significant impact on the at-home CPI, which measures prices of purchases primarily from grocery stores and supermarkets. Although retail prices increased for most food categories in 1996, prices actually fell for three food categories—beef and veal, fresh vegetables, and nonalcoholic beverages.

Large beef supplies along with weakened export demand provided U.S. consumers with plentiful supplies, leading to the beef and veal CPI falling 0.3 percent in 1996. Beef production is expected to be about the same in 1997, which should push up the CPI for beef and veal by 1-3 percent.

Retail *pork* prices increased nearly 10 percent in 1996, due to lower pork output, fast-paced exports in the first half of the year, and brisk demand for bacon in the fast-food industry. With 1997 pork production likely to remain near 1996 levels and export demand strong, the CPI for pork is expected to increase 3-5 percent in 1997.

Prices for *other meats* increased 3.6 percent in 1996 and are expected up 1-3 percent in 1997. Other meats include highly processed food items, with prices influenced more by the general inflation rate than by the cost of the meat inputs.

Continued strength in domestic and export demand along with higher feed prices boosted *poultry* prices 6.2 percent in 1996. Slower production increases in 1997 for broilers and turkeys, and lower production for total red meat during first-quarter 1997, should contribute to higher broiler prices. The CPI for poultry is expected to increase by 2 percent in 1997.

In 1996, prices for the major *fish* items (i.e., tuna, salmon, and shrimp) remained flat, and the CPI for fish and seafood went up 0.9 percent. It is expected to rise 2-4 percent in 1997 due to increased

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restrictions on foreign fish harvesting, and disease problems with foreign farm-raised shrimp. Imports account for about 40 percent of U.S. fish consumption.

Egg prices were sharply higher in 1996, jumping almost 18 percent. Strong domestic demand, especially from the fast-food industry, and foreign demand, especially for egg products, kept retail prices higher throughout the year. Continued increases in production during fourth-quarter 1996 and into 1997 should result in average 1997 prices below the high levels of 1996. The CPI for eggs should be level or decline slightly in 1997.

Strong domestic and export demand for dairy products, coupled with lower out-

put, increased the milk products CPI by 7 percent in 1996. Milk production in 1996 was restrained by high feed prices and forage quality problems. Production in 1997 is forecast to increase fractionally. The modest gain, along with the possibility of lingering damage from winter storms in the western states of California, Washington, Idaho, and Oregon, is expected to lead to a 2-4-percent rise in the CPI for dairy products in 1997.

Retail prices for *fats and oils* increased 2.4 percent in 1996 and are expected to repeat this rise in 1997. Price changes for these highly processed food items are influenced more by the general inflation rate than by the cost of the raw commodities, which include soybeans, corn, and canola.

Weather and growing conditions in the major *fresh vegetable* growing areas, especially California, Florida, Arizona, and Texas, were nearly perfect during most of 1996. The result was minimal disruption in the fresh vegetable market, with the CPI falling 2 percent in 1996. This year started out differently, however, with a severe Florida freeze in January damaging several fresh-market vegetables—squash, snap beans, bell peppers, eggplant, and tomatoes.

The impact on retail prices for these items will likely last through April. The bulk of most other fresh-market vegetables is grown in other states and was not affected by the freeze (AO March 1997). Although the fresh-vegetable CPI is expected to increase 6-7 percent the first 6 months of 1997, the annual increase should return to trend levels, at 3-5 percent.

Large supplies of oranges and western U.S. apples should moderate *fresh fruit* prices in first-half 1997. The fresh-fruit CPI is expected to rise 3-5 percent in 1997, after posting a 7-percent increase last year.

Domestic *sugar* production declined about 7 percent in 1996, as high prices for alternative crops and lower grower returns caused some producers to reduce sugar beet plantings. Along with lower sugar output, price increases for high-fructose corn syrup contributed to higher retail prices for selected sugar-related food items in 1996, boosting the CPI for sugar and sweets by 4.5 percent. With total sugar supplies expected up slightly in 1997, the CPI for sugar and sweets is expected to increase 2-4 percent in 1997.

*Cereal and bakery* products account for a large portion of the at-home food CPI—almost 15 percent. While higher grain prices helped push up retail prices for selected bakery products, retail price reductions for breakfast cereals tempered gains in the cereal-and-bakery CPI to just 3.9 percent in 1996. The CPI for cereal and bakery products is expected to rise 3-5 percent in 1997.

#### Modest Gains in Meat and Dairy Product Prices Foreseen for 1997

Consumer Price Indexes	Relative weights*	1994	1995	1996	Forecast 1997
	— Percent —	— Percent change from previous year —			
All items		2.6	2.8	2.9	3.2
All food	100.0	2.4	2.8	3.3	2.5 to 3
Food away from home	37.3	1.7	2.3	2.5	2 to 3
Food at home	62.7	100.0	2.9	3.3	3.7
Meats	12.2	19.5	0.5	0.1	3.5
Beef and veal	6.2	9.8	-0.8	-0.8	-0.3
Pork	3.4	5.8	1.7	0.7	9.9
Other meats	2.5	4.0	2.4	1.5	3.6
Poultry	2.7	4.4	3.4	1.4	6.2
Fish and seafood	2.4	3.9	4.5	4.8	0.9
Eggs	1.0	1.9	-2.4	5.4	17.9
Dairy products	7.4	11.8	1.8	0.8	7.0
Fats and oils	1.6	2.5	2.7	2.8	2.3
Fruits and vegetables	12.7	19.6	3.8	7.7	3.5
Fresh fruits, vegetables	8.9	13.5	4.6	10.3	2.8
Fresh fruits	4.5	7.4	6.6	8.8	7.0
Fresh vegetables	4.5	6.2	2.3	12.1	-2.0
Processed fruits, vegetables	3.8	6.1	2.2	2.2	5.0
Processed fruits	2.1	3.5	0.6	3.1	5.8
Processed vegetables	1.6	2.6	4.4	1.2	4.0
Sugar and sweets	2.1	3.3	1.4	1.7	4.5
Cereals and bakery products	9.2	14.9	4.1	2.8	3.9
Nonalcoholic beverages	5.0	7.7	7.5	6.9	-2.4
Other prepared food	6.5	10.4	2.6	2.4	3.4

\*First column: Bureau of Labor Statistics estimated weights—expenditure shares—as share of all food. Second column: weights as share of food at home.

Sources: Historical data, Bureau of Labor Statistics; forecasts, Economic Research Service.

Economic Research Service, USDA

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### How the CPI Overstates Food Price Inflation

The Advisory Commission to Study the Consumer Price Index (CPI) presented its final report to the Senate Finance Committee in December 1996. The report asserts that the overall CPI has overstated changes in the cost of living and that persistent and large overstatements have existed since the 1970's. The Commission's best estimate of the historic overstatement is 1.1 percentage points per year (adjusted for changes already made in the index), which results from four kinds of bias.

- *New product/quality improvement bias* results from a failure to account for quality improvements associated with new products. The Commission attributed somewhat more than half of the overall bias in the total CPI to new product bias, a problem that is very difficult and time-consuming to solve.
- *Formula bias* results from an inappropriate aggregation of price changes.
- *Substitution bias* results from lags in adjusting to changes in consumer expenditure patterns, particularly in response to changes in relative prices.
- *Outlet bias* results from failure to account for the price effects of changes in retailing. The CPI includes price changes only within retail outlets, not across outlets.

The bias in the food-at-home CPI is higher than for the overall CPI—probably closer to 1.9 percentage points per year—and is due primarily to the last three sources of bias. The Bureau of Labor Statistics (BLS), which publishes the CPI and has done much of the research identifying the sources of bias, is introducing changes that will have a noticeable effect on the food-at-home CPI.

In January 1995, BLS made a technical change in the way new price observations are introduced to the index. The previous method attached too much importance to items whose prices were rising and not enough importance to items whose prices were falling. The likely effect on the food-at-home CPI is to reduce its growth by 0.4 percentage points per year, starting in 1996.

BLS also began publishing experimental versions of the index, aimed at better handling other formula bias issues. The experimental indexes appear to reduce growth in the overall CPI by 0.25 percentage points per year, growth in the food-at-home CPI by 0.7 percentage points per year, and growth in the fresh fruit and vegetable index by 4.5 percentage points per year. The agency will begin publishing the experimental series in early 1997, and there is a good chance the new approach will be included in the official CPI by 1998.

Steps could be taken to handle substitution bias in the CPI, but that would require additional funding to substantially expand annual household consumption surveys. Further, the adjusted index would be published with a lag. Because of the expense and the publication time lag, such steps are less likely.

Outlet bias is estimated to have added 0.25 percentage points to the food-at-home CPI over the last decade. This estimate may decline if structural change toward larger and lower priced food stores slows.

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Only a small portion of the cost of producing cereal and bread—less than 10 percent—stems from the cost of ingredients, which include flour, sugar, and oil. Most of the cost is for processing and marketing. Competition for market share among the three leading breakfast cereal manufacturers led to retail price cuts for four consecutive months in 1996—an example of how the effect of market competition on retail prices can be stronger than commodity prices.

The CPI for *nonalcoholic beverages* fell 2.4 percent in 1996 due to retail price reductions for both coffee and carbonated beverages during part or all of the year. Coffee retail prices during the first 8 months of 1996 were down 19 percent compared with this period the year before. Competition between the leading soft drink companies during the 1996 summer Olympic games led to lower retail prices during the peak demand season, curtailing price gains for the entire year.

In 1997, however, the CPI for nonalcoholic beverages will likely increase 2-4 percent, due to higher wholesale coffee prices in the world market. The rise in wholesale prices has been triggered by a smaller-than-expected crop in Brazil and labor unrest in Colombia, the two major coffee producing countries.

*Miscellaneous prepared foods* are highly processed and are affected largely by changes in overall inflation. However, higher ingredient and raw material prices in 1996 did cause some manufacturing price increases in selected prepared foods, boosting the CPI for other prepared foods 3.4 percent in 1996. Competition among products should dampen further retail price increases in 1997, with the CPI for other prepared foods expected up 2-4 percent.

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